

Request for Clearance to Submit Review for
Outside Publication

ENDORSEMENT:

I have reviewed the attached review, entitled [redacted]
[redacted] prepared by [redacted]
[redacted] in my opinion, it does not contain
classified information available only from classified
sources, information available to the author solely
because of his employment with CIA, would not reflect un-
favorably upon CIA. It does not reveal in any direct or
indirect manner programs, sources, or methodologies
peculiar to intelligence production or operations.

STAT
STAT

25X1

Date: 5 July 1974

[redacted]
Chief, China Division

July 3, 1974

A Review of
Kang Chao, Capital Formation in Mainland China, 1952-1965

This book on capital formation in China, which carries Professor Chao into a new and important sector of the economy, is built on his earlier studies of industry, agriculture and construction. The work falls into three areas: Chapters 1 and 2 are an introduction, a discussion of the official data on capital construction and investment, and a brief examination of previous estimates by Western scholars; Chapters 3 and 4 present the derivation of Chao's estimates and as such are the heart of the book; and Chapters 5 through 8 analyze the rate of investment, the relative shares of construction and producer durables, and the allocation of investment to the various sectors of the economy.

In the first section he concludes that the official data on investment are relatively free of deliberate falsification, but their shortcomings distort the picture drawn from them. The main sources of this bias are identified as the incomplete coverage of the agricultural sector and the improper valuation of corvee labor and of imported machinery and equipment. Because of these and other problems with the official data, Chao limits his study to fixed capital formation and uses the commodity flow method to derive his estimates.

In the second section, series for the following components of fixed capital investment are derived: (1) construction and installation; (2) domestic production of machinery and equipment; (3) net imports of machinery and equipment; (4) office furniture and tools; and (5) other rural investment. For the period 1952-57, the estimates depend basically on Chao's earlier work on construction, on a recalculation of Professor Chu-yuan Cheng's index of machine building, and on foreign trade data published by China's trading partners.

For the period 1958-65, because of the scarcity of data, two separate estimates are presented. The first follows the procedure used for the earlier period. Chao rejects this estimate because he feels that one component, the index for the domestic output of machinery and equipment, greatly overstates the rate of growth. He derives an alternative estimate of the output of machinery and equipment from the data on imports and the claimed degree of self-sufficiency in machinery.

The third section shows the high rate of investment that China was able to maintain during the 1950s and violent fluctuations in the annual rate of change. It also raises the question of the relatively small share of producer durables in fixed capital formation in comparison with other low-income countries. And finally it shows the terrific concentration of investment in the modern and particularly in the industrial sector of the economy.

The results for the 1950s are of the same order of magnitude as those of previous studies by Western scholars. For the 1960s there are no other estimates with which to compare Chao's results, but the recovery of capital formation from the collapse of the Leap Forward does not seem rapid enough. First, the level of construction is considerably lower than that indicated by the availability of building materials, and second, the growth of the machine building industry is too low. Professor Chao concludes correctly that the first index for the machine-building industry -- the one derived from physical output estimates -- overstates the rate of growth, but I believe the alternative measure he derives from the data on self-sufficiency understates the growth. Unlike the more precise data for the 1950s, the figures for the 1960s are rounded to the nearest 5 percent, and a small rounding error can make a big difference in the estimated level of domestic production.* In addition it is probable the data are not as accurate as those published for the 1950s.

*Consider the effect of rounding 87.5 percent down to 85 percent:

<u>Rate of Self-Sufficiency</u>	<u>Domestic Production As a Multiple of Imports</u>
.85	5.7
.875	7.0

In this example, rounding would result in an error of about 20 percent.

Despite my feelings about some of the figures for the 1960s, the study is a valuable addition to the literature available on the Chinese economy. It illustrates both the strengths and the weaknesses of the Communist economic system. At a low level of income, voluntary savings are too low to finance development. Chao shows that investment is a function of economic institutions, that the Communist system was able to break out of the low income, low savings trap, but that the control exercised is two-edged. Without the checks provided by a market system, it is liable to excesses such as the Leap Forward that affect both savings and the level of income.

25X1

